

APPENDIX

NOTES FOR FOMC MEETING

July 2, 1991

Sam Y. Cross

When you met here in mid-May the dollar had entered a period of temporary stability. The exuberance of the dollar's recovery in February and March had faded in light of uncertainties about the timing and strength of the anticipated U. S. economic recovery and the dollar was fluctuating with no clear trend. Since then, however, the dollar ratcheted up another notch, and rose by about 5 to 6 percent on average in the intermeeting period, though the rise was nearly 8 percent against the mark and less than 1 percent against the yen. Sentiment toward the dollar remains positive; July has started out with further upward movement and there is a widespread view in the market that the dollar still has upside potential.

The latest boost in sentiment began in late May. A series of economic data, starting with housing and personal income, persuaded many market participants that the U. S. recovery was, in fact, underway and might also be more robust than previously foreseen. Soon thereafter, the dollar received further reinforcement from political and economic uncertainty in Germany, particularly following a state election victory by the opposition Social Democrats in early June. Although market participants were wary how the monetary authorities might respond to the dollar's renewed rise, they bid the dollar up, especially against the mark, during the first half of June.

As the dollar rose, market participants recognized that the rally might be causing problems for Germany and to a lesser degree Japan.

Throughout the spring, German officials had pointed to the need for a strong mark to assist the financing of unification. It was feared that, in both Germany and Japan, currency weakness might force the central banks to maintain tighter monetary conditions than were appropriate for purely domestic considerations. The market was watching for evidence that the authorities in those countries might try to forestall such moves by intervening to contain the dollar's rise and by seeking cooperation from the United States and others in those intervention efforts.

In fact, the Bundesbank did initiate a round of coordinated intervention with most other European central banks and the Bank of Japan on June 10. Although the United States did not join, these operations and expectations of similar ones later on served to dampen the dollar's upward momentum at times. By mid-June talk had begun to spread that the G-7 Finance Ministers and Central Bank Governors would meet prior to the July summit to arrange a major effort to cap the dollar's rise. So when such a meeting was announced for June 23, the dollar retreated sharply before steadying.

Nevertheless, underlying sentiment towards the dollar continued to be bolstered by prospects of near-term recovery in the U.S. economy. As a result, when the initial market interpretation of the G-7 communique was that it offered no new initiative to the dollar, at first the dollar rose. But, almost immediately, interpretive comments by a number of officials--from France, Japan, and Britain--caused the market to reevaluate its skepticism about the likelihood of coordinated G-7 intervention. Also, reports began to circulate that the

Bundesbank was selling U.S. Treasury securities. Market gurus speculated that the German central bank was either building its war chest for a major intervention or, alternatively, that it was preparing to buy back accumulated mark reserves from the Federal Reserve and the Treasury so that the United States would then be in a position to conduct large-scale intervention. In these circumstances, the dollar gave back most of its gains in the past week or so since the G-7 meeting.

Other developments last week also tended to weigh on other currencies and thereby helped add to the dollar's attractiveness. With respect to the German mark, uncertainty that a controversial withholding tax might be reimposed resurfaced last Thursday when the German High Court set a deadline for more effective taxation of investment income. This led to a sharp sell-off in all mark assets and a broad decline of the mark against other currencies. Also, the reemergence of turmoil in Yugoslavia supported the dollar and weighed on the mark, reflecting Germany's economic exposure to that nation.

The yen has generally been somewhat less weak than the mark. Nevertheless, the latest securities scandals have at times made market participants uneasy about foreign investors' reaction, and have led to some sapping of the yen's strength in the exchange markets as well as to renewed weakness in Japan's equity market. Yesterday, the Bank of Japan lowered its official discount rate one-half percentage point, to 5-1/2 percent. Although the timing of the move had not been widely expected, talk of a lowering of Japanese interest rates had been around for months and the stock market decline of recent days was seen by many as likely to argue for an earlier monetary policy action.

The U.S. monetary authorities intervened on only one occasion during the period; that was in late May when Sweden announced its decision to link the krona to the ECU. The change in Sweden's exchange rate regime had balance sheet implications for a lot of Swedish institutions that had borrowed dollars. With the announcement coming out late in Europe on a Friday, the dollar/mark market was the only one still open to absorb the hedging operations these institutions needed to do, and the rush to hedge prompted a temporary but sharp rise in the dollar against the mark. These pressures were met by substantial intervention by the Bundesbank and the Swedish Riksbank. The Desk sold \$50 million in cooperation with that effort.

The only other operation during the period is one we have already reported--the off-market currency exchange with the Bundesbank. As you know, we agreed to exchange, at market rates, DM 10 billion for approximately \$5.5 billion, with the Federal Reserve exchanging DM 6 billion and the Treasury DM 4 billion. These exchanges are to occur in installments, the first of which was for DM 4 billion, which settled on June 27, and the remaining six are each for DM 1 billion and will occur on agreed dates over the next six months. Entering this arrangement immediately reduced the Federal Reserve's exposure, or net open position, by the full DM 6 billion. The exchange produced for the Federal Reserve a realized profit of \$103.4 million on the first transaction and an estimated \$139 million more on the remaining six transactions.

Mr. Chairman, I would like to request the Committee's approval of the operations of the period.

July 1, 1991

FOMC MEETING NOTES
JULY 2 - 3, 1991

JOAN E. LOVETT

Desk operations during the intermeeting period were geared to maintaining unchanged reserve conditions, expected to be associated with Federal funds trading in the area of 5 3/4 percent. The borrowing allowance was raised for technical reasons in light of normal springtime increases in seasonal use. The allowance was raised in four steps by a total of \$125 million, bringing it to \$325 million. Actual borrowing ran a bit above the allowance over the first three periods, reflecting occasional use of the adjustment facility by larger banks. For the period in progress, it is running considerably higher in the early days in part because of reserve shortages at quarter-end.

The funds rate was reasonably steady throughout the intermeeting period, averaging pretty close to the 5 3/4 percent central point. The quarter-end saw relatively mild rate pressure, but skimpy reserve balances led to a firming by the close which has carried into the early days of this week.

Reserve management was pretty uneventful during the first two maintenance periods. Rising reserve needs were anticipated and were met through a combination of outright purchases and RPs, mostly of the customer variety. The purchases came to \$3.6 billion, including about \$1.1 billion of bills and notes purchased from foreign accounts and \$2.5 billion of bills

purchased in the market on May 29. The market generally expected a stable Fed policy stance but, near the outset of the period, a soft funds rate in conjunction with a weaker durable goods report generated some market discussion which the Desk dampened with a round of MSPs.

Reserve needs were much more uncertain in the third period, which was characterized by large revisions to the outlook moving through the period. Uncertainty about the timing and magnitude of June tax payments to the Treasury was the key difficulty. Many market analysts appeared to be having similar difficulty and, consequently, anticipated Desk operations on either side of the market depending on these flows. In fact, we drained reserves twice and added on three occasions, acting when the weight of the estimates and reserve market conditions suggested the need. The operations added on balance.

The period in progress showed a fairly sizable reserve need, and our early actions were designed to start meeting it as well as to assure sufficient clearing balances over the quarter-end weekend. However, market demand for these reserves was not there at the time as most participants apparently felt adequately positioned. Thus, dealers terminated early the bulk of the 4-day RPs we had arranged and gave us only meager propositions when we tried to replace them. As a result, clearing balances over the quarter-end weekend were skimpy, and we got \$1.5 billion of

borrowing. Given current and prospective needs, we again began supplementing our RPs with outright purchases from foreign accounts over recent days, buying a total of about \$300 million in the period underway.

Following your last meeting, market interest rates were, on the whole, generally steady over the remainder of May. Data at month's end soon gave rise to rumblings about an earlier-than-expected recovery, and the surprise increase in May NFP announced in early June put a focus on both an earlier and potentially stronger rebound. Market rates rose a solid 20 to 35 basis points by mid-June as the new outlook was factored in and, except for very short maturities, the increases came pretty much across the yield curve. Following the employment report, a fairly steady stream of data added to the notion that the economy had begun up the path to recovery, as did remarks by Federal Reserve officials.

Having discounted the recovery early on, differing views about its strength and sustainability caused some trimming in rates on Treasury issues over the balance of June. Market views on this score are divided. Some see a healthy though not vigorous rebound, and others still look for anemic growth or downside risks. Supporting arguments for each case have left participants in a guarded mode. The "standard" consensus probably calls for real growth around 3 percent over

articles on the health of the banking system and periodic drops in equity prices here and abroad acted at times to suppress the rate rise. The Treasury issued a net of \$24 billion in bills during the period. The auction held yesterday--for a record \$20.8 billion--brought average issuing rates of 5.59 and 5.71 percent, respectively, on new 3- and 6-month issues, compared with rates of 5.50 and 5.63 percent just prior to your last meeting.

Private short-term rates also rose by about 10 to 25 basis points. For most of the period, quality spreads widened only a little. The default by Columbia Gas System on some maturing CP elicited a fairly muted response in the paper of other issuers, apparently because its particular financial difficulties were deemed specific to the company. Despite the focus on the banking system, quality spreads there were also fairly quiescent--in fact modestly narrower--until late in the period. The ease with which this market slipped the other way suggests that the recent stability was tentative. The Wells Fargo announcement on June 25 caught the market off-guard and aroused fresh concerns about asset quality more broadly. Rumors of various banking problems surfaced over the remainder of the week. The so-called "TED" spread widened out by 9 basis points on the last week, with downward pressure on longer-term BHC debt and equity prices resuming.

After adjusting higher through mid-June, intermediate and longer Treasury maturities settled into a trading range. The long bond approached 8 5/8 percent briefly but receded back to around 8 1/2 percent thereafter. The Treasury raised some \$18 billion of new cash in this sector during the period. It appears that Treasury net marketable borrowing came in pretty close to the \$40 billion second quarter estimate provided by the Treasury at the time of the May refunding. Associated cash balances look to have finished the quarter about \$9 billion higher.

The Treasury's May 2-year note auction commanded a fair amount of market attention early on and again more recently. In that auction, as you recall, a few bidders stepped ahead of the market talk, spurring reports of concentrated holdings and fears of shortages. When the issue subsequently began to rise in price in both the cash and financing markets, cries of "foul ball" were heard from some participants. Others at the time seemed to feel that this was the byproduct of trading strategies that the market should be able to take in stride, so long as it did not pose a threat to the process going forward.

Market discussion of the matter seemed to fade when the issue began to move back toward more normal alignment on the yield curve, though it remained relatively expensive in financing markets. However, concern resurfaced later in June as the market

approached another auction of 2-year notes. Most participants were fearful of setting up pre-auction short positions given the prior experience. The normal spread between the outstanding and when-issued security widened out going into the auction and it has moved even further over recent days. Given the caution, the auction came a little behind immediate pre-auction when-issued trading. Meanwhile, the Treasury has been reviewing its auction procedures with a view to probable change amid signs of discomfort with the auction process.

On the whole, rates on intermediate and longer Treasury coupon issues ended the period about 15 to 20 basis points higher. In the 2-year area, rates were roughly 10 basis points lower to 10 basis points higher though there was a flare-up in volatility there today for reasons that are not entirely clear.

Finally, in other markets, corporate spreads remained quite tight despite sizable new issuance throughout the period. There is currently some debate in the market about whether such narrow spreads can be maintained. The municipal calendar was also large, in part reflecting heavy issuance of short-term notes going into the June 30 fiscal year-end of many states. A number of these entities are struggling with severe budget problems which placed some upward pressure on their yields. The Bridgeport bankruptcy filing generated little fallout.

Michael J. Prell
July 2, 1991

CHART SHOW PRESENTATION -- DOMESTIC ECONOMIC OUTLOOK

As you know, recent data have been almost uniformly positive, providing strong evidence of a turn in the economy. Chart 1 displays the Commerce Department's composite indexes of economic indicators. The leading indicators, in the top panel, have risen every month since January, and according to our LEI-based probability model, we can be highly confident now that a recovery is in train.

The coincident indicators, in the bottom panel, have begun to confirm the upturn, flattening out in April and edging up in May. This suggests that the trough month probably will be March or April, and I've used April and the second quarter in these and subsequent charts.

Of course, all this leaves some important questions unanswered--notably, what the character of the ensuing expansion will be and what it will bring in terms of inflation and the U.S. external position. Chart 2 begins the examination of these questions.

The top panel shows four-quarter percent changes in real GNP. It is apparent that the expansion we've projected for the next year and a half is more subdued than most of the prior upswings plotted. It is tempting to say, simply, that mild recessions, such as that we just experienced, naturally beget mild upturns. In fact, the correlation is quite good, but, given that it is based on a small sample, one might not want to depend on it. In any event, I know that

you would feel deprived if you did not have the benefit of our insightful--or at least lengthy--analysis of the forecast.

We see three major factors underlying the turnaround in the economy. The first two of these are basically the reversal of the negative forces unleashed by the Gulf crisis last summer: namely, the jump in oil prices and the sudden plunge in consumer and business confidence regarding economic prospects. The third factor is the interest rate decline fostered by the System and the easing in financial market conditions more generally, reflected in narrowing risk premia and improved access to the capital markets for many financial and nonfinancial firms.

Of these three influences, the monetary stimulus is perhaps the most difficult to assess, for the indicators in this area are rather ambiguous. For example, although interest rates have come down in recent quarters, they've not declined as much as in some other recessions, especially at the long end of the maturity spectrum. This could mean that the monetary impulse has been less, or perhaps that the expected returns on capital have held up better. Looking at the monetary aggregates, M2 hasn't accelerated the way it did in past recessions, but, of course, we no longer have the deposit rate ceilings that played such a big part in the past and there have been notable changes in patterns of intermediation that may be accommodating the flow of funds to investors with little adverse effect on aggregate demand. And then there is the rise in the dollar this year, which might suggest a restrained monetary policy, but may reflect, importantly, an elevation of expectations regarding U.S.

economic performance. Sifting through all of this, we conclude that the economy currently is benefitting from an expansionary monetary impulse, but probably one of lesser magnitude than those in some other cycles.

There are, to be sure, some other, sectoral considerations that distinguish this upturn from earlier ones, and these are reflected in the table at the bottom of the page. The table shows the contributions of various expenditure categories to the projected increase in real GNP, comparing the current upswing to those that began in 1961, 1970, 1975, and 1982. In light of the uncertainty about which quarter the NBER eventually will select as the latest trough, I've shown calculations based on both the first and second quarters of this year. As it turns out, it doesn't matter much which of those two quarters is used--the picture is fundamentally the same.

I'd offer the following observations on these data:

(1) The first-year GNP increase we've projected is smaller than the 5-1/2 percent average of the prior upturns; only the upturn after 1970, at 3.2 percent, fell short of the 6 percent mark.

(2) Inventory investment, the next-to-last line, is likely to provide its usual boost to production; aggressive destocking has laid the groundwork for a sizable swing in inventory investment, even while businesses maintain a tight hold on ratios of stocks to sales.

(3) As the memo item indicates, it is final sales that account for the smaller gain in GNP this time.

(4) Consumption, construction and government purchases all look to be areas of subpar contribution, while we think that exports

will make a relatively healthy contribution to GNP over the coming year.

I'll be exploring those relatively weak components of domestic demand in the next few charts, and Ted will be addressing the outlook for the external sector.

Turning to chart 3, a basic premise of our forecast is that the personal saving rate is so low now that it would be unreasonable to anticipate that consumer spending will outstrip the growth of disposable income. The saving rate was 3.6 percent in May, according to last week's release, and it edges up to just 4 percent in our projection.

One is given at least slight pause in this cautious assessment when one looks back at late 1982. Then, too, the saving rate was low by the standards of prior years and household debt burdens were historically high. Indeed, as you can see in the middle panels, at the end of the '82 recession, consumers themselves were reporting an unwillingness to use savings or to borrow for major purchases rather similar to what they are saying today. Yet spending proceeded to vastly outstrip income growth in the ensuing expansion. In contrast to 1982, however, we are starting at a lower saving rate and, as shown in the bottom panel, we are coming off a period of extraordinary accumulation of durable goods, rather than a deep recession in which an appreciable pent-up demand developed.

Our judgment is that the current concerns about financial stress in the household sector probably are, once again, overdone, but

that, unless there is a surge in household wealth like that in the 1980s, consumption is unlikely to outpace income growth.

In search of that income growth, then, let me turn to the construction sector--which is treated in your next chart. In past expansions, private construction activity--in particular, homebuilding--provided substantial impetus to job and income growth in the first year. The thrust probably will be considerably less impressive this time. Housing starts and sales have picked up in recent months and should increase further. But we see a couple of limiting factors on the supply side of the market. The first of these is illustrated in the top panel, which shows the remarkable rise in the number of vacant housing units during the past decade. A testament to the potency of builder optimism and lender profligacy, the existing overhang of unoccupied units is likely to damp prices and new construction in a good many markets. The other negative supply factor is the marked shift in credit availability for land acquisition and development, even in the single-family sector; we continue to think the problem here is often overstated, but we don't think it is non-existent. Many smaller, less well capitalized builders undoubtedly are encountering some difficulty in finding financing even for sound projects.

There is, of course, a similar problem in the nonresidential construction sector. As the middle panel shows, contracts for private nonresidential building--the solid line--have been trending downward for a while and construction activity has a considerable way to go to catch up. In past expansions, nonresidential construction has lagged

the general business upturn by a few quarters, but in this instance we expect that it may be at least a couple of years before construction turns around. Justifiably, in terms of the damage it has been doing to financial institutions, the commercial real estate bust has been the focus of much attention. The bottom left panel indicates that office vacancy rates remain very high, and with prices and rents remaining soft, lenders are likely to be preoccupied for some time with managing their losses and with avoiding new exposures. Other commercial properties also appear to be in ample supply; although the imbalance probably is less serious than that for offices, a significant upturn in building probably will be slow in coming. All that said, though, the panel at the right is intended to provide a reminder that these sectors represent rather small parts of the economy: investment in office and other commercial structures is less than a percent of GNP. In sum, as far as construction activity is concerned, it is residential--not nonresidential--building that is likely to be the important story in terms of subpar impetus to economic expansion over the coming year.

I've mentioned financial concerns with respect to both the household and business sector. While there clearly are some strains in the financial markets that will linger for a while, we don't believe that they represent a serious impediment to expansion--at least not to the kind of moderate upswing we're projecting. The top panel of chart 5 shows our projection of borrowing, scaled by nominal GNP. As you can see, we believe that the projected level of spending can be financed with still low rates of credit growth. The middle

panel reveals one reason why we don't anticipate heavy borrowing by businesses: namely, we believe that firms will not be engaging in the kind of leveraging that produced massive net share retirements--the red line--in the 1980s. Similarly, in the household sector, with real after-tax interest rates high on consumer loans, with asset values not providing the same support for expanded borrowing, and with the pressure less intense to buy new big-ticket durables, we expect borrowing to pick up only a bit in the period ahead. We believe that these private credit needs and those of the government sector can be met without undue strain on financial intermediaries.

Speaking of the government sector, chart 6 focuses on the federal component. The top panel compares federal purchases in this cycle versus other recent cycles. Notably, purchases are expected to be weaker in the coming year--the solid red line--than in any other expansion with the exception of that following the 1970 recession--the dashed red line. Interestingly, that too was a period of military retrenchment and, as I noted earlier, of relatively weak economic recovery.

The middle panel shows our measure of the impetus being delivered to aggregate demand by discretionary fiscal policy action. The budget agreement reached last year implies significant restraint during this recovery. This is a considerable departure from the experience in some earlier cycles, when there were tax cuts, social security benefit hikes, or other stimulative actions as the economy pulled out of the recession.

This difference is visible in the unified budget figures, shown below. When one strips out the foreign contributions to the Defense Cooperation Account and the effects of deposit insurance, the widening of the unified deficit this fiscal year is fairly mild--and in significant part explained by Desert Storm outlays.

Like the federal government, states and localities are facing significant budgetary constraints at present. The top panel of chart 7 shows that the operating and capital account deficit of the state and local sector has become very deep over the past few years. This gap has developed in a different way than did those in the past. The persistent gaps of the 1960s reflected heavy infrastructure investment, largely financed by federal grants or borrowing rather than by taxation; as you can see in the bottom panel, structures outlays have been trending upward once again in the past decade, but they don't loom as large relative to the overall size of the sector's expenditures as they did in the '60s. The deficits in the mid-'70s and early '80s were basically transitory phenomena related to cyclical shortfalls in revenues. But the recent deficit emerged during a period of economic expansion, and reflects in large measure a structural problem of tax limitations and growing demands for services. The pressures have been exacerbated by the imposition on states and localities of burdens mandated by federal initiatives--without commensurate grants.

In any event, these units are now responding in a variety of ways to the fiscal imbalance. We are seeing both higher taxes--some of which are adding directly to measured inflation--and spending

cutbacks. In many cases, those spending cutbacks are from very ambitious plans, and so they don't imply large absolute declines. And they often are in transfer payments or in compensation rates--neither of which is directly reflected in the GNP component, real purchases of goods and services. Nonetheless, we anticipate enough layoffs and construction postponements to produce a relatively weak contribution to economic expansion from state and local purchases.

Chart 8 summarizes the inflation outlook associated with our projection of a moderate expansion. The top panel shows our forecast that, as usual, much of the initial increase in output will be achieved through increases in labor productivity. Thus, as indicated in the middle panel, unemployment will be slow to drop off and is expected to remain well above 6 percent through next year.

The red shaded areas in the middle and bottom panels highlight periods when the actual unemployment rate has been above the nonaccelerating inflation rate of unemployment, or NAIRU. Not surprisingly, given that this estimate of the NAIRU is derived from the observed relation of unemployment and inflation, you can see that these periods have generally witnessed decelerations of consumer prices. Because we anticipate that the slack in the labor market will remain significant, and pressures on plant capacity modest, we expect to see inflation trending downward through 1992.

Ted will now continue the briefing.

E. M. Truman
July 2, 1991

Chart Show Presentation -- International Developments

Chart 9 summarizes the staff's outlook for the U.S. external accounts. The major factors affecting that outlook are presented in the box at the top of the chart.

The principal factor is the recovery of U.S. domestic demand which will stimulate demand for imports. At the same time, we expect a moderate pickup in growth on average in the major foreign industrial countries. This will help to support U.S. recovery.

On the negative side for domestic growth, we are projecting that most of the recent strength of the dollar will persist over the forecast period. On our weighted-average basis, with the rise today, the dollar has risen close to 6 percent since the May Committee meeting. We continue to think that some of the influences tending to push the dollar up are temporary, and that the dollar will drift off a bit from its recent highs. However, we are now projecting that the dollar will average about 5 percent higher over the forecast period than in the May Greenbook. This tends to restrain the domestic expansion as well as inflation.

A neutral element in our outlook is the assumption that oil prices will remain near current levels. This is based on our belief that Saudi Arabia will adjust its production to

avoid any substantial price fluctuations, especially as Iraq and Kuwait resume exporting.

The lower panel summarizes the effects of these various factors on our projection of U.S. external balances. As the red line indicates, real net exports of goods and services will make a small negative net contribution to U.S. real GNP over the forecast period -- about 20 billion 1982 dollars over the seven quarters from the first quarter of this year through the end of next year. Meanwhile, the current account is projected to settle down to a deficit of about \$45 billion by the fourth quarter of this year after the contributions to the Defense Cooperation Account are no longer coming in. Next year, the deficit should widen to somewhat more than \$50 billion. However, compared with several years ago, deficits of this size would be a substantial improvement both in absolute terms and as a percentage of GNP.

The next chart summarizes recent developments with respect to exchange rates and interest rates. As is shown by the red line in the top panel, the dollar through June on average had appreciated about 15 percent in real, or price-adjusted, terms since its low of February [July 2 about 2 percent above June average]. On this basis, the dollar was only about 3 percent above its average value since February 1987, the post-Louvre period. Roughly the same relationship holds for the Deutschemark and the yen; however, in nominal terms against the DM, the rate today is essentially the same as at the Louvre meeting [183.05 compared with 153.65 for the yen].

The dollar's rise over the first half of 1991 appears to have been fueled by the quick and successful end of the Gulf War and, more recently, by prospects of a stronger U.S. recovery than earlier anticipated. At the same time, special factors have affected some of the other currencies. Political factors within Germany and in the Soviet Union and, more recently, Yugoslavia have weighed on the DM along with a growing sense that the Bundesbank is constrained not to move aggressively against incipient inflation forces in that country. Thus, as is shown in the box at the left in the middle panel, so far this year through the end of June, the dollar appreciated 21 percent against the DM, but only 3 percent against the yen, and it depreciated slightly against the Canadian dollar.

The black line in the upper panel indicates that U.S. real long-term interest rates have risen relative to rates abroad this year. It is clear from the box at the right in the middle panel and the charts in the lower panel that, while U.S. short-term interest rates have fallen more than rates abroad, U.S. long-term rates have risen somewhat at the same time that rates abroad have tended to decline. Developments since last Friday have tended to reinforce these trends in long-term rates. Such a shift in the structure of interest rates is consistent with the expectation of a recovery in the U.S. economy, the likelihood that U.S. interest rates will be higher at some point in the future (particularly relative to foreign rates), and, therefore, the strengthening of the dollar that we have seen.

Cyclical patterns abroad vary considerably from country to country. The top panels of Chart 11 illustrate the very different patterns of industrial production in the major industrial economies. Production in Japan and Germany is still expanding at quite rapid rates on a year-over-year basis. As is suggested by the data on consumer prices presented in the middle panels, these countries still face what for them is high inflation.

Meanwhile, Canada and the United Kingdom remain in recession, though we think that the Canadian economy may be pulling out of its decline. Data on consumer price inflation in these two countries are distorted by a number of special factors: In Canada, by the introduction of the Goods and Services Tax and, in the United Kingdom, by the removal of the influence of rising mortgage interest rates and the poll tax. Nevertheless, enough slack has opened up in both economies that inflation pressures are receding. Production is weak in France and Italy, pressures on capacity have been reduced, and unemployment is rising. As a consequence, there has been a further narrowing of the gap between inflation in these countries and inflation in Germany. Indeed, the inflation gap between France and Germany essentially has been eliminated.

As is summarized in the box at the bottom of the page, we anticipate that growth will be slowing in Germany and Japan over the balance of this year following very strong first quarters. Inflation remains a concern for the authorities in these countries.

Meanwhile, we think we can detect tentative signs of pickup in some of the weaker economies.

Against this background, we expect that monetary policies will remain cautious, but interest rates may decline further in some countries as inflation eases. We expect that fiscal policy in Germany will become somewhat tighter after the expansion this year, assuming policy is not paralyzed by the political process. Fiscal policies are likely to be on the contractionary side on average in the other countries.

The next chart summarizes our projection for growth and inflation abroad. The upper left panel shows that foreign growth, weighted by shares in U.S. nonagricultural exports, slowed during 1990. Growth in the first half of this year remained at about the same weak rate as in the second half of last year. We are projecting a recovery toward 3 percent over the second half of this year -- a bit less pronounced than the projected recovery of the U.S. economy -- and a further rise to near 3-1/2 percent next year -- somewhat stronger than U.S. growth. As can be seen in the box at the right, the major foreign industrial countries -- the G-6 countries -- account for most of the pickup in foreign growth on average.

The middle panel provides greater detail on our forecasts for the G-6 countries. While economic activity in Germany and Japan has held up well on balance through the first half of this year, we expect that reported real GNP actually declined in the second quarter. After this pause, growth is projected to be moderate in the second half, followed by somewhat

more rapid expansion next year. Growth slowed in France and Italy at the end of last year and in the first half of this year partly under the influence of higher oil prices and a decline in confidence. Both factors have now turned around, and we are expecting a modest pickup in the second half of the year and in 1992.

From the standpoint of our non-agricultural exports, Canada and the United Kingdom are important markets; Canada is our largest market, and the United Kingdom is our fourth largest after Japan and Mexico. We anticipate that the recessions in Canada and the United Kingdom will come to end in the second half of the year, if they have not already, and this should provide a boost to demand for U.S. exports. In Canada, in particular, orders, retail sales, and housing starts are pointing to a pickup. In the United Kingdom, the story is more of a bottoming out and a recovery of confidence. Growth in these countries next year should be respectable but not buoyant, that is, a bit less than the estimated growth of potential output.

Partly as a consequence of the projected moderate recovery and expansion in the G-6 countries other than Germany and Japan, inflation is expected to decline substantially in these countries, as is shown in the lower left panel of the chart. However, some of this improvement is a statistical artifact associated with special one-time factors, such as the Goods and Services Tax in Canada, that will not be present in 1992. Nevertheless, the gap between underlying inflation in these countries and the average rate in Japan and Germany is

projected to narrow substantially. As is shown in the box at the right, the gap between U.S. inflation and the average for all of the G-6 should be fairly small.

Chart 13 summarizes various influences on two important components of the outlook for our external accounts: nonagricultural exports and non-oil imports. Using our econometric model, we have tried to decompose the sources of expansion and contraction affecting these broad categories of merchandise trade. In the case of nonagricultural exports, the top panel, the striped bars show that these exports have been expanding, and are expected to continue to expand, at annual rates of 30 to 40 billion 1982 dollars. As is shown by the red bars, foreign growth over the second half of 1990 and the first half of 1991 has made a very modest contribution to that growth, but in the forecast period, the contribution will increase substantially. Meanwhile, relative price effects, which include not only the dollar's performance but the also behavior of prices and costs here and abroad, have been and will be important in 1991, but will decline in significance next year.

Turning to non-oil imports, the lower panel, the turn in U.S. growth, the red bars, is the dominant factor producing the swing in non-oil imports. While relative prices were less of a positive factor boosting imports in the first half of this year, compared with 1990, they do not have a major influence in our outlook for non-oil imports.

My last chart considers the external sector as the transmission mechanism from the rest of the world to the U.S.

economy. In particular, it addresses the influence of the dollar's rise since February, and the possible consequences of continued weak growth on average abroad. To construct the alternative scenarios presented in the chart, we employed the staff's econometric models and used as a baseline the Greenbook forecast extended through 1993, with M2 growth at 5-1/2 percent and U.S. real GNP growth at 2-1/2 percent.

In the first alternative, we assumed the dollar remained at its February level, almost 15 percent lower than what is built into the current Greenbook forecast. However, the federal funds rate is unchanged from the assumption underlying the baseline. By itself, the February Dollar scenario would imply somewhat higher growth of real GNP this year and substantially higher growth in 1992 and 1993. In contrast with the baseline, the lower level of the dollar is sustained, and its effects tend to cumulate. By the end of 1992, the unemployment rate would be back at 5-1/2 percent, and it drops below 4-1/2 percent by the end of 1993. Not surprisingly, the inflation of GNP prices picks up noticeably by 1993.

One curious feature of this scenario is that foreign growth is higher on average in 1993 than in the baseline. The reason is that relative to our baseline forecast, the Canadian dollar appreciates only slightly against the U.S. dollar but depreciates against the non-dollar currencies; this tends to stimulate the Canadian economy as does the faster U.S. growth. Moreover, we have assumed that interest rates in Canada track interest rates in the United States; as a consequence, they

decline in real terms along with U.S. rates, which also stimulates the Canadian economy. Higher growth in Canada outweighs lower growth in Japan, Germany and the rest of European countries compared with the baseline forecast.

Overall, the U.S. current account deficit at the end of 1993 is somewhat more than half its size in the baseline.

In assessing this alternative scenario, it is interesting to recall that the interest rate assumption that went along with the lower dollar exchange rates in the staff's judgmental forecast back in February was higher than what we now are assuming -- the federal funds rate was about 100 basis points higher. The level of U.S. economic activity projected in February for the fourth quarter of 1992 was almost exactly the same as we are now projecting.

We tried a modification of the February Dollar scenario in our econometric models. In it, the dollar remained at its February level, but the federal funds rate was adjusted to leave the path of U.S. real GNP essentially the same as in the baseline forecast. Our models suggest that to achieve this result, the federal funds rate today would have to be about 130 basis points higher now and increase about another 20 basis points or so over the course of 1992. Given all the factors that can affect our forecasts, this correspondence of judgmental and model-based results is remarkably close. In essence, it can be said that the decline in the funds rate has offset the unexpected strength of the dollar.

The second alternative scenario hypothesizes continued weak foreign growth. We manipulated the demand side of the models to ensure that foreign growth, weighted by U.S. nonagricultural exports, remains at about 1-1/2 percent -- roughly the rate that prevailed over the second half of 1990 and the first half of 1991. Again, the federal funds rate was unchanged from the baseline.

Such a scenario of weak foreign growth has little effect on the growth of U.S. real GNP this year, but it would chop off about 3/4 of a percentage point next year, and almost twice that much in 1993. As a consequence, the performance of GNP prices is considerably better than in the baseline. However, the current balance deteriorates substantially.

To compensate for the lower foreign growth, the models suggested that the funds rate would have to be about 50 basis points lower over the second half of this year and roughly 100 basis points lower by the end of next year.

I would caution the Committee that this second scenario is rather extreme. While we do not have perfect foresight about the foreign outlook, and it certainly could be somewhat weaker in the short term, we believe the chances are very small of sustained weakness on the scale assumed for purposes of constructing this alternative.

On that reassuring note, I'll turn our presentation back to Mike Prell.

Michael J. Prell
July 2, 1991

CHART SHOW PRESENTATION -- CONCLUSION

The final exhibit summarizes the forecasts you provided last week. There doesn't appear to be vast disagreement among you: all of you project a moderate upturn in activity, declining unemployment, and inflation moving below the recent trend by next year. Whether there was as much consistency in the assumptions you made regarding policy will, of course, become clearer in the discussion ahead.

Because the law requires that we report on how our objectives relate to the Administration's economic forecast, I've shown their current numbers--which are those from February. The Mid-session budget review is due later this month, and it will include new numbers. My sense is that the changes will be small, perhaps mainly a reduction in the forecast of inflation, bringing it closer to your central tendency.